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The bond-market outlook

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Are global bond markets too complacent? That's the question being asked by investors concerned about issues including Donald Trump's presidency, impending changes to the make-up of the U.S. Federal Reserve's policy-making panel and the possibility that the three major central banks will all be tightening monetary policy in concert. These developments, taken together, could lead to higher yields within the forecast horizon. However, our thinking is that any uptick would be an overreaction, and, that when the dust settles, longer-term structural forces such as aging populations and highly indebted economies will likely prevent yields from straying much from the range that has been in place for about six years.

Let's start with Trump. Assume that, sometime this year, he succeeds in getting Congress to enact his proposed tax cuts, deregulatory measures and fiscal spending. Their passage would result in expectations of stronger economic growth and higher inflation, and, coupled with a smattering of trade protectionism, likely lead to higher bond yields and lower fixed-income returns. Two other possibilities exist: one is that Trump fails to sell legislators and the public on these policies. The other possibility is, of course, that Trump's tenure will be cut short, for whatever reason. In both cases, bond yields would likely fall.

The next task facing Trump is the possible appointment of a new Fed chairman, and the selection of as many as four of the remaining 11 members of the Federal Open Market Committee (FOMC). Investors are uncertain at this point whether the continuity that has characterized the Fed since the financial crisis will persist. Some analysts speculate that Trump is likely to choose appointees who are keen to abandon the Fed's commitment to keeping asset prices high and bond yields low – at least until the fruits of recovery are more evenly distributed. They worry that Trump will appoint FOMC leadership whose adherence to models might push up policy rates faster than warranted. Should the future FOMC choose to interpret the Fed's mandate on price stability and full employment differently, the pace of policy-rate hikes could pick up and the Fed's balance sheet could shrink more quickly than the market can digest. The result might be the worst outcome: an environment of rising bond yields and declining stock prices.

Yellen's four-year term as head of the FOMC expires in February, and three slots are empty following the April resignation of Governor Tarullo. Fischer's seat could also open up if he chooses to step down when his vice-chairman term expires in mid-2018. It is almost certain, therefore, that the FOMC will have a very different composition by this time next year. One possible replacement for Yellen is John Taylor, the Stanford University professor known for calibrating policy based more on economic statistics than the macroeconomic "big picture." A lack of obvious FOMC candidates and the absence of a clear frontrunner for chairman may create short-term volatility.

One risk of a reformulated FOMC is that the panel proceeds to reduce the Fed's balance sheet in a way that upsets financial markets. The prevailing view is that the Fed must move slowly in paring its US$4.5 trillion balance sheet to avoid rattling financial markets, and we expect the reduction to start at US$10 billion a month, or about 2.5% of the portfolio. But just because the Fed is talking about reducing its balance sheet, doesn't mean that it actually wants to do too much, or even needs to. After the 2008 banking crisis, global policymakers introduced regulations that, in effect, require banks to keep more money on deposit at the Fed, and those deposits are among the very assets swelling the Fed's balance sheet. That liquidity, as well as the natural growth of money in circulation, mean that the Fed's massive balance might even be a semi-permanent feature of the financial system. We believe that a partial reduction in the Fed's balance sheet is manageable, but we fear investors might get spooked if the Fed moves too fast or explicitly states that it plans to offload most or all of the assets that it holds.

The balance sheets of the European Central Bank (ECB) and the Bank of Japan (BOJ) are also worth monitoring given that officials at both are discussing when and whether to slow their growth-supporting asset purchases. Europe's economy is again expanding and the threat of disinflation has eased, and BOJ officials feel it would be prudent to follow Europe's lead in scaling back the bank's bond buys, or at least to say they are considering it. With all three major central banks tightening policy at the same time, bond yields would be under pressure to rise. Our fear is that investors may not be ready for simultaneous monetary tightening, and that the initial reaction may be for yields to rise over the short term.

Another force that could push bond yields higher is the tenacity of the current economic expansion, which has given investors the confidence to favour risky assets over the safety of government bonds. The U.S. economy has plowed ahead, albeit slowly, even as doubts grow about President Trump's ability to win passage of his economic package, and economic statistics in Europe are on the upswing. Also supporting bond yields is Europe's success so far in avoiding the election of leaders opposed to further economic and political integration, specifically in France and the Netherlands. The same sentiment is reflected in rising support for Angela Merkel ahead of September elections in Germany.

We fear, however, that investors are overly confident that financial markets can continue to rise indefinitely. This calm is nicely illustrated in the skyrocketing popularity of passive investing, largely in stock-index funds, as trillions of dollars of central-bank stimulus has lifted all boats and encouraged investors to pay less attention to the underlying assets in which they invest. Investors are also largely ignoring the possibility that widespread anger generated by rising income inequality will mutate into destabilizing social unrest. These developments suggest that longer-term risks are under-priced, and that bond yields would surely plunge from already low levels were they to materialize.

To review, our forecast is for periodic spikes in bond yields over the next 12 months, presenting opportunities for investors to add bonds at more attractive rates. Accumulating government bonds at higher yields should produce better total returns as long-term structural forces will continue to hold yields down.

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